

*Martin J. Benison, Comptroller
One Ashburton Place
Boston, MA 02108*

April 30, 2002

*To the Citizens of the Commonwealth of Massachusetts,
Governor Jane Swift, and Honorable Members of the General
Court*

I am pleased to transmit to you a draft conversion of the Commonwealth's fiscal 2001 Comprehensive Annual Financial Report in the format prescribed under Government Accounting Standards Board Statements 34, 35, 37 and 38. This report is the first step in a process that will culminate by the release of the Commonwealth's fiscal 2002 Comprehensive Annual Financial Report, on or before December 31, 2002.

This draft conversion was performed with information that was available as of June 30, 2001. That information was accounted for under standards that existed previous to this implementation. A wealth of other information was gathered from the Commonwealth's various agencies necessary to produce this draft conversion. The purpose of this conversion is to present to you what the Commonwealth's financial statements will look like under these new standards.

This draft conversion report is presented in three sections: **Introductory**, **Financial** and **Statistical**. The report is the primary means of reporting the Commonwealth's financial activities. The objective of this new model is to provide a clearer picture of our government as a single, unified entity, will retaining certain traditional financial information previously presented.

This **Introductory Section** contains an overview of the Commonwealth's economic performance, a review of current initiatives and summary financial data. This section contains information that existed as of June 30, 2001. The **Financial Section** contains a Management's Discussion and Analysis section, which examines and summarizes financial and other results. It also contains Government-wide Financial Statements, which are the new statements presented under the new standards. It contains Fund Financial Statements for Governmental Funds, Proprietary Funds, Fiduciary Funds and Statements for Component Units. The section also includes the Notes to the Financial Statements, Required Supplementary Information and Other Supplementary Information. The **Statistical Section** contains selected financial and demographic information.

Generally Accepted Accounting Principles ("GAAP") require that management provide a narrative introduction, overview and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement MD&A and should be read in conjunction with it. Usually, the Commonwealth's MD&A can be found immediately following the independent auditor's report from Deloitte and Touche, LLP. However, for this 2001 translation document, we are providing the MD&A immediately following this transmittal letter.

PROFILE OF THE COMMONWEALTH

This report consists of management's representations concerning the finances of the Commonwealth. Consequently, management assumes full responsibility for the completeness and reliability of all the information presented in this report. To provide a reasonable basis for making these representations, management of the Commonwealth has established a comprehensive internal control framework that is designed to protect the Commonwealth's assets from loss, theft, or misuse and to compile sufficient reliable information for the preparation of the Commonwealth's financial statements in conformity with GAAP. Because the cost internal controls should not outweigh their benefits, the Commonwealth's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement. As management, we assert that, to the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

INTERNAL CONTROL ENVIRONMENT

Chapter 647 of the Acts of 1989, places authority and responsibility for internal controls with the head of each executive department, constitutional office, and branch of government. The Office of the Comptroller issues internal control guidelines and the Office of the State Auditor may investigate departments with risk of internal control weaknesses.

The Office of the Comptroller continues to deliver training sessions and workshops for department managers regarding risk assessment and mitigation in the Commonwealth's highly automated environment.

Absolute assurance with respect to internal control is prohibitively expensive. Using risk assessment criteria set forth in the guidelines and stressed in the training, the objectives of the Commonwealth's internal control structure are to provide management and the public with reasonable assurance that internal control systems do not have material weaknesses.

The Office of the Comptroller has been working to further strengthen the guidance for Internal Controls for the Commonwealth through a statewide Internal Control Campaign. Using the Committee of Sponsoring Organizations ("COSO") Report of the Treadway Commission as a basis, the office has issued an expanded and updated Internal Control Guide for managers of the Commonwealth. The goal of this effort is to present a sound set of practices that enhance financial credibility throughout the Commonwealth.

As part of the fiscal year 2001 audit, the Commonwealth continued the emphasis on the analysis of departmental internal control plans. The goal is to have departments not just think of their plans as fiscal control documents but management documents that assess risk across all programmatic areas of the department and document strategies to mitigate those risks. The plans, which included developing customized training for particular departments, scheduling monthly internal control classes, devoting hundreds of single audit hours in the review of internal control plans, development of internal control models and risk assessment techniques and making managers generally aware of the importance of these controls. As a result of this emphasis, the number of current year findings have decreased, the findings repeated from previous years have decreased, and the findings resolved in one year reached an all time high. We clearly have the attention of our departments and plan to continue this focus next year through the continuation of the education process, expansion into program areas to compliment our success in the financial arena, and increased communication of internal information at all levels of government.

REPORTING ENTITY

The financial statements incorporate 156 departments. These departments include the various agencies, boards, and commissions, the 25 institutions of higher education, the judicial and legislative branches of government, and constitutional offices.

The departments record their daily financial operations in the state accounting system called the Massachusetts Management Accounting and Reporting System ("MMARS") operated by the Office of the Comptroller.

In addition, the financial statements include 38 independent public authorities and the State Employees' and Teachers' Retirement Systems. These component units meet the criteria for inclusion in the reporting entity in accordance with GAAP, which are further described in Note 1 to the financial statements.

ACCOUNTING SYSTEM AND BUDGETARY CONTROL

MMARS is the computerized, statewide accounting system used by all departments to control and account for their financial activity under the statutory basis of accounting. The financial operations of the authorities and certain non-appropriated higher education funds are accounted for through their own independent accounting systems.

MMARS is designed to satisfy all requirements of the Commonwealth's statutory basis of accounting and financial reporting. Any additional information needed to prepare financial statements according to GAAP is provided through a combination of MMARS system-generated data, information compiled by departments, and the submission of audited financial statements from certain independent authorities.

During fiscal year 2002 and for the next three years, the Commonwealth will take steps to upgrade MMARS from a "green screen" mainframe-based system to one that is an Internet based application. We believe that it is time to upgrade the system to take advantage of current and future technologies to position the Commonwealth to provide seamless integration of its e-government applications to its "back-end" budgetary control and financial management systems.

CASH AND INVESTMENTS

The State Treasurer and Receiver – General controls cash and investments with the exception of pension assets, which are managed by the Pension Reserves Investment Trust. Each department deposits cash receipts daily into a Treasury controlled bank account. Weekly and daily warrants for disbursements are prepared by the Comptroller, and reviewed and approved by the Governor's Council; the Treasurer issues disbursements. The banking and disbursement process has been recently streamlined to optimize the use of electronic funds transfer and electronics benefits transfer.

A system of bank depository and disbursement accounts and "lockboxes" are employed by the Treasurer's Office to maximize daily cash balances. The Treasurer manages these cash balances in The Massachusetts Municipal Depository Trust, ("MMDT") and other funds to optimize interest earnings. The Treasurer's Office invests cash from these general accounts in short-term securities and other investments. A discussion of cash and investments is presented in Note 3 to the general purpose financial statements.

The Treasurer is also responsible for quarterly cash flow plans, weekly variance reporting and, jointly with the Executive Office for Administration and Finance, annual and quarterly cash management plans. Taxes and non-tax inflows, warrants, other outflows, and short and long-term borrowings are monitored against these plans.

Fiscal year 2001 is the eighth year of the Commonwealth's implementation of the United States Cash Management Improvement Act ("CMIA.") The CMIA requires the states to measure interest income on federal funds drawn from the U.S. Treasury prior to disbursement, and for the U.S. Treasury to measure interest income on funds drawn down subsequent to disbursement. A settlement of interest due to or due from the Commonwealth and federal government is computed.

CAPITAL ASSETS

These financial statements include the capital assets of the Commonwealth. A discussion of capital assets accounting is included in the MD&A that is part of the basic financial statements. More detailed information about capital assets can be found in the notes to the financial statements.

DEBT

The Commonwealth funds its capital appropriations by authorizing the issuance of long-term bonds. General obligation bonds are backed by the full faith and credit of the Commonwealth, including the Commonwealth's power to levy additional taxes to ensure repayment of the debt. The Commonwealth has issued special obligation debt, backed by certain revenue streams and grant anticipation notes, which are secured by future federal grant cash flows. To limit the Commonwealth debt burden, and control the degree to which debt service creates pressure on the operating budget, the Administration has implemented a five-year capital spending plan. This administrative policy has existed for several years.

In fiscal year 1997, Standard and Poor's upgraded the rating for the Commonwealth's General Obligation Debt from "A+" to "AA-". The effect of the capital spending plan policy, the acceleration of funding of the Commonwealth's pension liability and the string of operating surpluses were cited as reasons for the upgrade. The current credit ratings from Moody's is Aa2 and Fitch Investor Services is AA-.

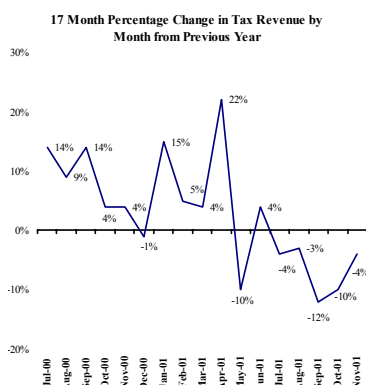
As authorized by state finance law, the State Treasurer may utilize short-term borrowing to support governmental cash flow. Other debt consists of certificates of participation and capital lease agreements. Such financing arrangements are used to acquire capital assets, for example computer equipment and motor vehicles. The Commonwealth continued to utilize this form of financing in fiscal year 2001.

Additional information on Commonwealth debt, including guaranteed debt of independent public authorities, is presented in Notes 7, 8, and 12 to the financial statements.

RISK FINANCING

The Commonwealth assumes the risk of loss for property damage and personal injury, breach of contract, condemnation proceedings, and other alleged violations of law, and is defended by the Attorney General's Office in such cases.

ECONOMIC CONDITIONS AND OUTLOOK FOR THE COMMONWEALTH



I am pleased to report that through fiscal year 2001 the Commonwealth's financial condition remained strong, however the picture is changing. Since fiscal year 1994 this office has reported that the fiscal health of the Commonwealth is strong. The Commonwealth has enjoyed over seven years of prosperity and growth. The Commonwealth's unemployment level shrunk during the time period by 42% from 205,000 citizens unemployed in 1994 to 86,000 in 2000. At some point the economy was anticipated to slow down. As of June 30, 2001, the Federal Reserve Bank of Boston, in its monthly "New England Economic Indicators," reported that the number of people unemployed in our Commonwealth has increased to 113,000 or a rate of 3.4%. The rate increased to 4.2% in October, 2001. Both rates are under the "full employment" threshold of 5%, but the rate is rising. The same report shows that the consumer confidence index has slipped in our Commonwealth from a rate of 156 a year ago, to 94 as of October 2001 with future expectations for a slower economy. This softening economy is reflected in tax receipts for the first half of fiscal year 2002. This softening economy is reflected in tax receipts for the first five months of the fiscal year. The Secretary for Administration and Finance revised his tax revenue estimate downward from nearly \$15.7 billion to over \$14.9 billion, a decrease of over \$700 million. As of the end of November, tax collections totaled nearly \$5.7 billion, or \$450 million below the same period in fiscal year 2001. These results portray a real decline from last year's economic boom.

Prudent planning throughout the 1990s has left the Commonwealth well positioned for this economic slow down. The Commonwealth ends fiscal year 2001 with a \$3 billion surplus in its budgeted funds. Since fiscal year 1991, the Commonwealth's Stabilization Fund, sometimes called the "rainy day fund," has grown from a balance of \$59 million to over \$1.7 billion, its maximum. In addition, in the final set of appropriation acts for the fiscal year, the Commonwealth set aside over \$579 million in fiscal year 2001 surpluses. Of this amount, \$422 million was used to balance the fiscal year 2002 budget, with the remainder held in stabilization. In previous years, year-end transfers of budget surpluses were made to the capital project funds to make strategic investments for the management of the Commonwealth's capital budget, to defease high interest debt that otherwise could not be refunded, and to increase reserves. Similar transfers may not be able to be made during this period of economic slowdown.

The results of fiscal year 2001 helped prepare the Commonwealth for this changing economy. For the eleventh consecutive year, revenues have exceeded expenditures in the governmental funds. As of June 30, 2001, I am now pleased to report a positive GAAP governmental fund balance of \$4.5 billion (fund perspective) and a \$5.1 billion entity-wide net asset balance. In fiscal year 1990 and fiscal year 1991, the Commonwealth resorted to over \$1.8 billion in deficit borrowing to start down the road of putting its fiscal house in order. In 1991 the Statutory Basis Fund Balance in the budgeted funds was \$237 million. This same balance when computed in accordance with GAAP, was a deficit of \$761 million. Today's GAAP fund balance in excess of \$4.4 billion in the fund perspective, is the strongest evidence of the Commonwealth's over decade long commitment to conservative budgeting and strategic investments in its future stability to prepare for this slowdown. But, this fund balance contains a considerable amount of funds that are not "free cash." \$1.7 billion of this balance is reserved for Stabilization. Another \$1.8 billion is reserved in capital project funds containing bond proceeds that must be used for the Central Artery / Tunnel Project ("CA/T.")

The Stabilization Fund is a strategic tool at decision makers' disposal to assist the Commonwealth through this difficult time. It may be used in three circumstances. The first is to make up any difference between the actual state revenues and the allowable state revenues in the case of a revenue shortfall. The second is to replace federal funds in the case of a shortfall. Finally, the fund may be used for any event that threatens the health, safety, welfare, or stability of the Commonwealth, including an economic downturn.

As portrayed in the graphics of the monthly change in tax revenues for the past sixteen months, the slowdown is definitely here. The Commonwealth has begun to tap these resources in connection with budget reductions as part of the recently enacted fiscal year 2002 budget. The administration and Legislature have wisely taken a balanced approach using \$806 million from reserves combined with necessary reductions in service levels throughout the state. This assures that the structural gap faced in preparing the fiscal year 2003 budget will be less ominous and reserve will be available in future years. This plan to use surpluses judiciously over multiple years is essential to exiting this economic downturn with a service level that can be supported with available resources.

BUDGETED FUNDS OPERATIONS

The portion of state finances that generates the greatest degree of interest is the Budgeted Funds. These funds include the General, Local Aid, Highway, and certain Special Revenue Funds, which comprise the annual state budget. These funds are also important to analyze as the bulk of their revenues are derived from taxation and federal reimbursements. The expenditures in these funds are largely general governmental operations, Medicaid, Local Aid, debt service and public assistance.

Generally, funds for the Commonwealth's programs and services must be appropriated by the Legislature. The process of preparing a budget begins at the administrative level early in the fiscal year preceding the fiscal year for which the budget will take effect. The legislative budgetary process begins in late January (or, in the case of a newly elected Governor, not later than March) with the Governor's submission to the Legislature of a budget recommendation for the fiscal year commencing in the ensuing July. By statute, the Legislature and the Governor must approve a balanced budget for each fiscal year, and no supplementary appropriation bill may be approved by the Governor if it will result in an unbalanced budget. However, this is a statutory requirement that may be superseded by an appropriation act. Both the House and the Senate through their respective Ways and Means committees propose budgets. A conference committee then develops a compromise budget for consideration both houses, which upon adoption is sent to the Governor. The Governor has the right to veto the budget in whole, disapprove or reduce specific line items. The Legislature may then override these actions by a two – thirds vote of both the House and the Senate.

During the course of the fiscal year, the Comptroller monitors budgetary accounts and notifies the Secretary of Administration and Finance and the House and Senate Committees on Ways and Means whenever the appropriation for a particular account has been depleted. Whenever the Governor believes that existing appropriations are insufficient to provide for projected expenditures under authorized programs, the Governor may seek supplemental appropriations for particular programs or spending items. The Secretary of Administration and Finance is required to compute projected deficiencies and, under Section 9C of Chapter 29 of the General Laws, the Governor is required to reduce allotments, to the extent lawfully permitted to do so, or submit proposals to the Legislature to raise additional revenues or to make appropriations from the Stabilization Fund to cover such deficiencies. The Supreme Judicial Court has ruled that the Governor's authority to reduce allotments of appropriated funds extends only to appropriations of funds to state agencies under the Governor's control and not, for example, to local aid.

Highlights of the fiscal 2000 and fiscal 2001 budgets include (expressed in millions – statutory basis):

Fiscal 2000 and 2001 Budgets - Statutory Basis (expressed in thousands)								
	Amount Appropriated		Percentage of Total Appropriations		Increase / (Decrease) from Prior Year		Percentage Increase / (Decrease)	
	2000	2001	2000	2001	2001		2001	
General Government	\$ 1,695,206	\$ 1,657,529	7.6%	7.6%	\$ (37,677)			-2.2%
Judiciary	558,896	605,737	2.5%	2.8%	46,841			8.4%
Direct Local Aid	4,710,178	4,984,417	21.1%	22.8%	274,239			5.8%
Medicaid	4,324,593	4,727,216	19.4%	21.6%	402,623			9.3%
Pensions	987,374	1,041,483	4.4%	4.8%	54,109			5.5%
Higher Education	1,009,227	1,109,719	4.5%	5.1%	100,492			10.0%
Environmental and Recreation	242,938	256,572	1.1%	1.2%	13,634			5.6%
Communities and Development	156,571	159,467	0.7%	0.7%	2,896			1.8%
Health & Human Services	4,144,748	4,316,168	18.6%	19.8%	171,420			4.1%
Transportation and Construction	1,367,233	208,522	6.1%	1.0%	(1,158,711)			-84.7%
Education	384,551	450,288	1.7%	2.1%	65,737			17.1%
Public Safety	1,133,267	1,207,673	5.1%	5.5%	74,406			6.6%
Economic Development	61,485	66,068	0.3%	0.3%	4,583			7.5%
Elder Affairs	198,228	222,989	0.9%	1.0%	24,761			12.5%
Consumer Affairs	49,368	54,880	0.2%	0.3%	5,512			11.2%
Labor	76,249	79,337	0.3%	0.4%	3,088			4.0%
Debt Service	\$ 1,203,243	\$ 704,032	5.4%	3.2%	\$ (499,211)			-41.5%
Total Budgeted Appropriations	\$ 22,303,355	\$ 21,852,097	100.0%	100.0%	\$ (451,258)			-2.0%
Other Financing Uses	977,182	1,588,464			611,282			62.6%
Total Budgeted Appropriations and Other Financing Uses	\$ 23,280,537	\$ 23,440,561	100.0%	100.0%	\$ 160,024			0.7%

FINANCIAL INFORMATION

GENERAL GOVERNMENT FUNCTIONS

Most financial operations of the Commonwealth are reported in the Governmental Funds. The Governmental fund type includes all funds where the Commonwealth imposes its sovereign authority to collect revenues and authorize expenditures. This includes all Budgeted Funds (General and several Special Revenue Funds,) all other (non-budgeted) Special Revenue Funds, and the Capital Project Funds. When viewed as a whole, these funds portray the Commonwealth's comprehensive governmental financial activity.

The Commonwealth bonds for capital projects in arrears. These expenditures and financing sources are recorded in the Capital Projects Funds component of the Governmental Funds total. The practice of bonding in arrears allows for a high degree of certainty in project spending, mitigating a potential adverse tax consequence.

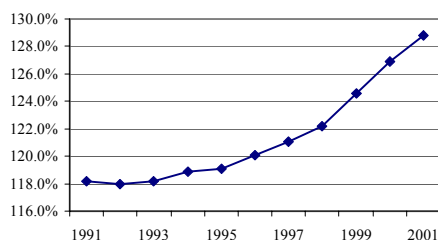
Governmental Funds: Revenues and Other Financing Sources – Statutory Basis
(expressed in thousands)

	Amounts		Percentage of Total		Increase (Decrease)	Percentage
	<u>2000</u>	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>from Prior Year</u>	<u>Increase / (Decrease)</u>
Taxes	\$ 15,702	\$ 16,753	41.0%	43.5%	\$ 1,051	6.7%
Federal Reimbursements	4,364	4,668	11.4%	12.1%	304	7.0%
Federal Grants	1,360	1,450	3.6%	3.8%	90	6.6%
Lotteries	3,913	4,138	10.2%	10.7%	225	5.8%
Assessments	487	585	1.3%	1.5%	98	20.1%
Motor Vehicle licenses and registrations	285	311	0.7%	0.8%	26	9.1%
Fees, investment earnings, etc.	2,014	2,212	5.3%	5.7%	198	9.8%
Proceeds of general obligation bonds	1,762	1,912	4.6%	5.0%	150	8.5%
Proceeds of refunding bonds	-	999	0.0%	2.6%	999	100.0%
Other operating transfers	<u>8,403</u>	<u>5,487</u>	<u>21.9%</u>	<u>14.2%</u>	<u>(2,916)</u>	<u>-34.7%</u>
Total revenues and other financing sources	<u>\$ 38,290</u>	<u>\$ 38,515</u>	<u>100.0%</u>	<u>100.0%</u>	<u>\$ 225</u>	<u>0.6%</u>

Governmental Funds: Expenditures and Other Financing Uses – Statutory Basis
(expressed in millions)

	Amount Expended		Percentage of Total Expenditures		Increase / (Decrease)	Percentage
	<u>2000</u>	<u>2001</u>	<u>2000</u>	<u>2001</u>	<u>from Prior Year</u>	<u>Increase / (Decrease)</u>
General Government	\$ 1,477,214	\$ 1,536,263	6.8%	7.2%	\$ 59,049	4.0%
Judiciary	547,845	588,065	2.5%	2.8%	40,220	7.3%
Direct Local Aid	4,673,942	4,969,440	21.6%	23.3%	295,498	6.3%
Medicaid	4,269,990	4,642,342	19.7%	21.8%	372,352	8.7%
Pensions	986,303	1,040,121	4.6%	4.9%	53,818	5.5%
Higher Education	996,032	1,102,258	4.6%	5.2%	106,226	10.7%
Environmental and Recreation	218,357	234,642	1.0%	1.1%	16,285	7.5%
Communities and Development	138,098	140,841	0.6%	0.7%	2,743	2.0%
Health & Human Services	3,975,451	4,220,765	18.4%	19.8%	245,314	6.2%
Transportation and Construction	1,360,073	199,938	6.3%	0.9%	(1,160,135)	-85.3%
Education	364,437	393,117	1.7%	1.8%	28,680	7.9%
Public Safety	1,097,615	1,184,873	5.1%	5.6%	87,258	7.9%
Economic Development	35,451	51,310	0.2%	0.2%	15,859	44.7%
Elder Affairs	189,760	214,036	0.9%	1.0%	24,276	12.8%
Consumer Affairs	46,293	51,127	0.2%	0.2%	4,834	10.4%
Labor	55,600	53,843	0.3%	0.3%	(1,757)	-3.2%
Debt Service	<u>1,193,329</u>	<u>675,839</u>	<u>5.5%</u>	<u>3.2%</u>	<u>(517,490)</u>	<u>-43.4%</u>
Total Budgeted Appropriations	<u>21,625,790</u>	<u>21,298,820</u>	<u>100.0%</u>	<u>100.0%</u>	<u>(326,970)</u>	<u>-1.5%</u>
Other Financing Uses	<u>4,422,332</u>	<u>1,773,045</u>			<u>(2,649,287)</u>	<u>-59.9%</u>
Total Budgeted Appropriations and Other Financing Uses	<u>\$ 26,048,122</u>	<u>\$ 23,071,865</u>	<u>100.0%</u>	<u>100.0%</u>	<u>\$ (2,976,257)</u>	<u>-11.4%</u>
Governmental Funds - Net Increase in Fund Balance		<u>\$725,576</u>				

**Massachusetts vs. United States
Year to Year Per Capita
Net Income Change
1991 – 2001**



ECONOMIC AND FINANCIAL PROSPECTS FOR THE FUTURE

Massachusetts and the rest of the nation are in the midst of a profound economic downturn exacerbated by the events of September 11th. Even though our Commonwealth is home to many world-renowned institutions of medicine and higher education, both public and private, keeping the economy relatively stable and full of ingenuity, no sector is immune from the economy. Tourism, a significant component of our economy, is our third largest industry. Most economic data points to a significant drop in activity in the short term for the tourism industry. According to a report released by the Massachusetts Office of Travel and Tourism on October 10, 2001, the lodging industry component alone is expected to lose \$241 million in sales this year post September 11th. Overall, the lodging industry, according to the report is expected to generate over \$324 million less in sales this year than in 2000.

Massachusetts' employment had been growing steadily since 1992. The Massachusetts' seasonally adjusted unemployment rate, currently at 3.4%, remains below the national seasonally adjusted rate of 4.5% as of June 30, 2001. Massachusetts' rate however, has risen quickly from a low of 2.3% in December of 2000. Also as of June 30, 2001, Commonwealth per capita income still outpaced the nation as shown in the Massachusetts vs. United States Year-to-Year Per Capita Income Graph. This graph shows that Massachusetts's per capita income level has been and is increasingly growing compared to the rest of the nation.

The Commonwealth, with an international reputation for medical, cultural, historical, and educational institutions, remains the economic and educational hub of New England. The Commonwealth's economy remains diversified but its strongest component is its knowledge-based technology and service industries.

Massachusetts' infrastructure provides strong support for this knowledge-based economy. There are over 120 colleges and universities located in Massachusetts, and the 2000 US Census has estimated that 35% of the residents over age 25 have earned bachelor's degrees, compared to an estimate of 25.1% for the United States as a whole. Our capital, Boston, has over 20 hospitals and three medical schools.

Inflation continues to largely be in check. The Boston consumer price index though has risen 4.9% from July 2000 to July 2001, as opposed to only 3.0% for the rest of the country.

The Commonwealth did not finalize its fiscal year 2002 budget until December 5th. In the absence of a budget, the Commonwealth had operated under a provisional budget of \$22.6 billion, virtually all of which was comprised of the lower of the House or Senate budget proposals for each respective budgeted line item. Budgeted revenues and other sources, as estimated by the Executive Office for Administration and Finance, however, were projected at approximately \$21.5 billion, including transfers and other receipts. The estimate assumes tax revenues will be 7.1% lower than the fiscal year 2001 actual collections of \$16.0 billion, after accounting for sales tax funds dedicated to the Massachusetts Bay Transportation Authority (“MBTA”). This estimate also reflects the impact of two tax cuts effective for calendar year 2001.

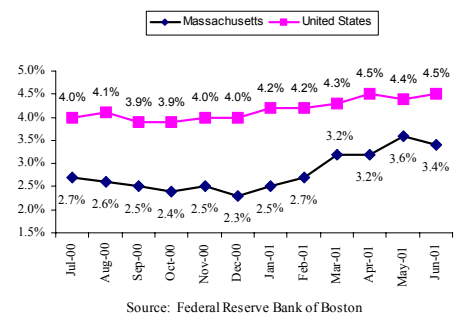
On November 7, 2000 Massachusetts’s voters approved two initiative programs that reduced personal income taxes beyond what was in the fiscal year 2000 budget. A 5.85% rate was effective for tax year 2000 and a 5.8% rate was effective on January 1, 2001. The voters reduced the 2001 rate to 5.6%, the 2002 rate to 5.3% and thereafter to 5%. This rate reduction has an impact of \$135 million in fiscal year 2001 rising to \$1.2 billion when fully implemented in fiscal year 2004. Economic theory suggests that the tax reduction will return to the Commonwealth in the form of increased spending activity and therefore, higher tax receipts. In the short run, it will also force the Commonwealth to live within the means that the citizens have stipulated.

Charitable donations will also be deductible from earned income beginning in tax year 2001. This has an estimated impact of \$80 million in 2001 and \$192 million when fully implemented. The charitable deduction will help stimulate the not-for-profit sector in the Commonwealth.

After accounting for vetoes and overrides in the budget as passed, the Executive Office for Administration and Finance projects the Commonwealth’s total budgeted expenditures and other uses in fiscal year 2001 at \$22.1 billion. This estimate assumes the spending in the Commonwealth will decrease by 1.4% from fiscal year 2000.

The Administration is engaged in an extensive mid-year review of this estimate. The Governor will release her recommended budget for fiscal year 2003 in late January, at which time the fiscal year 2002 forecast may be revised.

Monthly Unemployment Rate July 2000 – June 2001



SIGNIFICANT ACCOMPLISHMENTS

In fiscal year 2001, there were a number of significant accomplishments that demonstrate accountability and sound financial management.

GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the Commonwealth for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2000. The Certificate of Achievement is a prestigious national award, recognizing conformance with the highest standards for preparation of state and local government financial reports. This is the eleventh consecutive year that the Commonwealth has received this award.

On both a statutory and GAAP basis, the Commonwealth has maintained a positive fund balance for the tenth consecutive year. The Commonwealth Stabilization Fund balance, sometimes called the “rainy day” fund, has grown to its limit of over \$1.7 billion, representing the Commonwealth’s reserves for future purposes. In addition, the Commonwealth reserved \$579 million in a transitional escrow fund, largely being used for fiscal year 2002 purposes to help soften the economic blow.

The non-tax revenue optimization campaign was very successful in fiscal year 2001. With special authorization in the budget, a task force was comprised of key persons from the Executive Office for Administration and Finance, the Budget Bureau, and the Comptroller’s Office.

The task force provided leadership and sponsored projects by which outside experts were engaged on a contingent fee basis, and departments optimized various sources of non-tax revenue (such as federal reimbursement) by over \$203 million during fiscal year 2001. The initiative is dedicated to optimizing all collection potential within the framework of existing fee structure and program authorizations. The non-tax revenue optimization campaign continues in fiscal year 2002.

RECOMMENDATIONS AND CONCLUSIONS

The Commonwealth has many accomplishments in fiscal year 2001 of which it can be proud. A large number of projects to enhance or re-engineer business processes with new technology have been performed.

The Executive Office of Health and Human Services released a new system, MassCares, designed to provide all its departments and clients information that will enable them to manage services in a holistic manner. In addition, the Commonwealth release it’s new intention based web portal Mass.Gov. providing citizen easy access to information and service when they want it. Quick passage of the Information Technology bond is critical to future releases of these new services as well as other projects that will insure the Commonwealth keep pace with new technologies to enhance service to citizens.

The Office of the Comptroller continued to enhance its MassFinance website at <http://www.massfinance.state.ma.us>, adding the ability of

citizens, employees and vendors of the Commonwealth to access government information they want – when they want it. Commonwealth vendors can now access their remittance information, including scheduled payment and actual payment information, on-line at their convenience. Most recently, MassFinance was enhanced to allow citizens as well as municipal officials the ability to query local aid payments and assessments. In support of the e-Government initiative, the Office of the Comptroller continues to make improvements enhancing this website by bringing more information and services to the public.

Prior to HRCMS, 68% of employees received their pay through direct deposit. Today, over 93% do, reducing banking costs across the Commonwealth. All payroll deductions have also moved to electronic processes. Checks and paper reports have been replaced with electronic payments and data files for all payroll deductions, such as purchases of transit passes, insurance, annuities and payments among the Commonwealth departments. This project eliminated the control risks and inefficiencies associated with the payment payroll expenditures.

Building upon the observations in this letter, a detailed review of these financial statements suggests the need for action to further improve and strengthen state finance law and fiscal practice.

The Commonwealth should define the term “Chief Fiscal Officer” in law. Central to our partnership with CFO’s is ensuring they are empowered to do the job we ask of them. Too often, a department’s Chief Fiscal Officer is not directly accountable to the Chief Executive Officer of the department. Too often, the CFO does not have the proper functions reporting to them, enhancing internal controls. We will work to pass legislation strengthening the CFO’s role.

The legislature should enact early retirement legislation (ERIP). The current economic climate forces governments to reduce expenditures and act more efficiently. The recently enacted budget makes difficult budget reductions throughout state government. Now state managers are challenged to implement those decisions. ERIP is a valuable tool that will reduce forced separations through layoffs and provide managers with a valuable tool to manage more efficiently.

The Commonwealth must constantly monitor and update its systems and controls. We have asked each department, at its highest levels, to assess its risks and target controls to manage those risks efficiently and effectively. Toward this end, the Office of the Comptroller has continued a multi-pronged effort to improve controls throughout the Commonwealth. This effort must continue.

The Commonwealth must ensure that its bills are paid on time. A solid reputation of timely bill payments benefits both our business partners and the taxpayers. During fiscal year 2000, this office began a campaign with the Chief Fiscal Officers in the 154 state departments to improve the percentage of bills paid within 30 days. The timing and focus on bill paying improved the Commonwealth's bill payment track record this year to 84% of all bills paid within 30 days. This effort will continue until we have reached and maintained a 95% level.

The Commonwealth should reduce the number of funds and eliminate funds that have chronic deficits. The Commonwealth currently maintains over 100 governmental funds to record its financial activity. This excess number of funds fragments the Commonwealth's financial picture. Many of these funds have structural imbalances leading to chronic deficits. The effort to reduce the number of funds should continue. A fund should be a self balancing set of accounts where decision makers want to set aside a specific set of revenues to fund a specific set of activities. Nineteen of the 57 budgeted funds are in the environmental fund group. Fifteen of these nineteen funds contribute to accumulated deficits of \$96.7 million in this fund group.

Cash flow requires careful attention. In difficult times, the Commonwealth cashflow requires careful attention. Much of the Commonwealth surplus funds are reserved and held by the Treasurer segregated from pooled cash. At the same time, many of the Commonwealth deficit funds represent an unbudgeted drain on cash flow. The Commonwealth needs to develop a carefully orchestrated plan to insure sufficient cash is available to make timely payments throughout the fiscal year.

The Commonwealth should continue to emphasize optimization of both tax and non-tax revenues. This statewide campaign has generated nearly \$989 million in revenues since fiscal year 1996. The revenue optimization strategy should continue.

I again would like to express my thanks to the many dedicated people within the Office of the State Comptroller. We have had another successful year within the office. I am proud to have all the employees on my team to help tackle these and other difficult issues of the future.

Respectfully submitted,

Martin J. Benison
Comptroller